

**BEFORE
SOUTH CAROLINA PUBLIC SERVICE COMMISSION
DOCKET NO. 2013-59-E**

In the Matter of:

Application of Duke Energy)	
Carolinas, Inc. for Adjustment)	Docket No. 2013-59-E
of Rates and Charges Applicable)	
to Electric Service in South Carolina)	

Surrebuttal Testimony

of

Kevin W. O'Donnell, CFA

On Behalf of

South Carolina Energy Users Committee

July 16, 2013

**BEFORE
SOUTH CAROLINA PUBLIC SERVICE COMMISSION
DIRECT TESTIMONY OF KEVIN W. O'DONNELL, CFA**

1 **Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS**
2 **ADDRESS FOR THE RECORD.**

3 A. My name is Kevin W. O'Donnell. I am President of Nova Energy
4 Consultants, Inc. My business address is 1350 Maynard Rd., Suite 101,
5 Cary, North Carolina 27511.

6

7 **Q. ON WHOSE BEHALF ARE YOU PRESENTING TESTIMONY IN**
8 **THIS PROCEEDING?**

9 A. I am testifying on behalf of the South Carolina Energy Users Committee
10 (SCEUC), which is an industrial trade association in South Carolina.
11 Many of SCEUC's members take retail electric service from Duke Energy
12 Carolinas (Duke or the Company) and will be impacted by the
13 proceedings in this case.

14

15 **Q. DID YOU PREVIOUSLY SUBMIT DIRECT TESTIMONY IN THIS**
16 **PROCEEDING?**

17 A. Yes, I submitted direct testimony on behalf of SCEUC on July 1, 2013.

18

19 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL**
20 **TESTIMONY?**

21 A. The purpose in this surrebuttal testimony in this case is to respond to the
22 rebuttal testimonies of Company witnesses Hevert and Shrum.

23

1 **Q. DO YOU AGREE WITH MR. HEVERT'S ANALYSIS OF THE**
2 **GENERAL DIFFERENCES BETWEEN YOUR COST OF**
3 **CAPITAL FINDINGS VERSUS HIS FINDINGS?**

4 **A.** In general, yes, I believe Mr. Hevert did identify the overall differences
5 between his testimony and my testimony.
6

7 **Q. HOW DO YOU RESPOND TO MR. HEVERT'S**
8 **RECOMMENDATION THAT THE COMMISSION IGNORE ALL**
9 **GROWTH RATES, WITH THE EXCEPTION OF EARNINGS**
10 **GROWTH RATES, IN THE DCF MODEL?**

11 **A.** As I indicated in my direct testimony, it is incumbent upon a good analyst
12 to present all the growth rates to the Commission, and logically discuss
13 why he uses some growth rates and not others. I presented all the available
14 growth rates in my testimony and logically discussed why I recommended
15 growth rates in the high end of my range. Mr. Hevert did not present such
16 a thorough analysis. Instead, he limits his analysis to a select few
17 companies and then chooses to show the Commission the method that
18 produces only high growth rates for use in the DCF model.
19

20 This Commission has a difficult job and limiting the amount of available
21 data it can see makes its job more difficult. Mr. Hevert's analysis presents
22 only growth rates that are skewed upward whereas I present a full range of
23 available data and an accompanying explanation of that data so the
24 Commission can have a full understanding of what the market sees in the
25 Duke profile.
26

27 **Q. PLEASE EXPLAIN WHY YOUR COMPARABLE GROUP IS SO**
28 **MUCH LARGER THAN THE COMPARABLE GROUP USED BY**
29 **MR. HEVERT IN THIS CASE.**

1 A. I used 33 companies in my comparable group as opposed to Mr. Hevert
2 using only 11 companies in his group. Again, I believe in presenting as
3 much information as possible to the Commission. Mr. Hevert's group is
4 limited in size and represents a very small cross section of the industry as
5 compared to my group that is much more representative of the electric
6 utility industry.

7
8 **Q. DO OTHER RATE OF RETURN WITNESSES SHARE YOUR**
9 **VIEW OF USING LARGER COMPARABLE GROUPS IN ROE**
10 **ANALYSES?**

11 A. Yes. In Duke's North Carolina retail rate case, the Public Staff of the
12 North Carolina Utilities Commission retained Dr. Ben Johnson to prepare
13 a ROE analysis of Duke. During cross-examination from intervenors in
14 that case, Dr. Johnson stated he used a large group of companies and
15 disagreed with the smaller group of companies used by Mr. Hevert in his
16 North Carolina testimony.

17
18 **Q. WHAT DID DR. JOHNSON RECOMMEND IN DUKE'S NC**
19 **RETAIL RATE CASE?**

20 A. Dr. Johnson recommended a ROE range in Duke's North Carolina case of
21 7.84% to 9.07% (NCUC Docket No. E-2, Sub 1026, testimony of Ben
22 Johnson, p. 9) before agreeing to the settlement of 10.2%. Clearly, the
23 initial analysis that Dr. Johnson and I performed were much more in-line
24 with one another than Mr. Hevert's extreme analysis.

25
26 **Q. DOES THE ORS SUPPORT A 10.2% ROE IN THIS CASE?**

27 A. The ORS accounting and engineering staff filed testimony supporting a
28 revenue requirement using a 10.2% ROE. However, it filed no testimony
29 by a financial analyst or economist justifying a 10.2% ROE and its impact
30 on the utility or its customers.

1
2 **Q. HOW DO YOU RESPOND TO MR. HEVERT'S ATTEMPTED**
3 **REBUTTAL OF YOUR CITATION OF DR. ROGER IBBOTSON'S**
4 **STATEMENT REGARDING FUTURE MARKET RETURNS**
5 **BEING IN THE RANGE OF 6% TO 8%?**

6 A. Mr. Hevert does nothing to refute the point I raised in this section of my
7 testimony. In the Morningwatch article I cited in my testimony, Dr.
8 Ibbotson and Jack Bogle of The Vanguard Group state the reasons why the
9 markets are fundamentally different today than in years past. For the
10 reasons stated by both gentlemen, they believe future market returns will
11 be in the range of 6% to 8%. Mr. Hevert, however, goes on to re-state
12 history and states his market return of 13% is what history has returned
13 since 1926. In other words, Mr. Hevert totally misses the point of the
14 Morningstar article. Quite frankly, Mr. Hevert is unwilling to
15 acknowledge how different markets are today versus their historical
16 performance.

17
18 I think it is very important to understand Mr. Hevert's testimony in this
19 proceeding. He relies on data developed by a former Duke ROE witness,
20 Dr. Roger Ibbotson, but then he totally discards the statement of Dr.
21 Ibbotson that market returns will be in the neighborhood of 8%. To the
22 contrary, Mr. Hevert would have this Commission believe that market
23 returns will continue to run along at 13% per year.

24
25 **Q. DOES MR. HEVERT ACCURATELY DESCRIBE YOUR**
26 **COMMENT ABOUT UTILITY STOCKS BEING SIMILAR TO**
27 **BOND INVESTMENTS?**

28 A. No, Mr. Hevert, again, totally misses the point I was making by my
29 statement that, in today's market, utility investments are like bond
30 equivalents. As I point out in my testimony, utility investors tend to be

1 individuals or groups that desire current income and are willing to give up
2 higher long-term growth for higher current income. Bond investments are
3 very risky today due to the fact that interest rates are very low. If interest
4 rates rise, long-term bond investments will fall precipitously. Utility
5 stocks, on the other hand, have the ability to sustain less of a price decline
6 than bonds because they offer some price appreciation through growth. As
7 a result, with utility dividend yields currently at the same levels as 30-year
8 bonds, utility stocks are seen as bond-equivalents in today's market.

9
10 Mr. Hevert's comments in this section of his rebuttal testimony point out
11 another fundamental difference in his ROE analysis and that of myself.
12 Throughout my presentation in this case, I have attempted to give the
13 Commission a real-world view of the financial markets. My testimony is
14 based on my work as a financial analyst in the utility industry as well as
15 my years of working in money management. As a money manager, I know
16 what it is like to sit down with clients and discuss portfolio returns. The
17 financial analyst that relies too heavily on academia to explain his point is
18 one that is long on theory and short on practicality. With all due respect to
19 Mr. Hevert, I am afraid he has fallen into this trap of academia versus
20 reality.

21 **Q. HOW DOES THE PROPOSED ROE OF 10.2% COMPARE TO**
22 **AUTHORIZED RETURNS FOUND ACCEPTABLE BY OTHER**
23 **STATE REGULATORS?**

24 **A.** Only one other state jurisdiction, Michigan, has granted a higher ROE
25 than 10.2%. In looking at the results found on Exhibit KWO-4 from my
26 direct testimony, the Commission can see that there have been 18 cases,
27 excluding the Virginia cases that I exclude since the ROEs are
28 legislatively set, decided to-date where a ROE was specified in the final
29 order. The only ROE granted that was higher than 10.2% is the Consumers

1 Energy case in Michigan. In 15 of the 18 cases cited, the authorized ROEs
2 were lower than 10.2%.

3
4 Furthermore, in the cases decided to-date in 2013, the average equity ratio
5 granted by state regulators is 48.62% as compared to that of 53% here.
6 When the 53% equity ratio requested in this case is combined with the
7 10.2% ROE, the resulting overall rate of return in this case is
8 disproportionately high relative to other states and a burden to consumers
9 in South Carolina.

10
11 **Q. PLEASE EXPLAIN WHY AN ROE OF 10.2% COUPLED WITH**
12 **THE 53% EQUITY RATIO IS HIGH RELATIVE TO OTHER**
13 **STATES AND A BURDEN TO SOUTH CAROLINA CONSUMERS.**

14 **A.** As I stated in my direct testimony (page 31), the cost of common equity is
15 more expensive than the cost of debt. To be specific, on a pre-tax basis,
16 the cost of common equity is approximately 3 times more expensive than
17 the cost of debt. In this case, neither any intervenor nor the ORS has
18 contested the 53% equity ratio requested by Duke. However, the high
19 equity ratio in this case reflects the low financial risk of the Company and
20 must be combined with a commensurate return on equity. In comparison
21 to what other states have granted utilities in their jurisdictions, the
22 authorized equity ratio average of 48.62% is significantly lower than the
23 53% that will be requested by Duke in this case. As a result, in
24 comparison to other state findings, the authorized ROE in this case should
25 be equal-to or less-than the average ROE of 9.77% found to-date in other
26 states. A finding of an allowed ROE of 10.2% coupled with a 53% equity
27 ratio will increase rates to consumers beyond what is fair and reasonable
28 in relation to other state regulatory commissions.

29

1 **Q. HOW DO YOU RESPOND TO THE COMPANY'S POSITION**
2 **THAT CONSUMERS SHOULD CONTINUE TO PAY ITS**
3 **EMPLOYEES DEFINED BENEFIT PLANS?**

4 A. In Surrebuttal Exhibit KWO-1, I have provided an article from
5 Reason.com that notes that 17% of companies still offer defined benefit
6 plans. In its rebuttal testimony, Duke counters that 42% of Fortune 500
7 companies either still offer a defined benefit plan for existing employees.
8 However, Duke does not dispute the fact that its new employees still
9 receive a defined benefit plan that puts 100% of the risk of the plan
10 underperformance on ratepayers, not Duke. I trust that Duke's comments
11 in this docket about existing employees still receiving defined benefit
12 plans is a sign that Duke is studying the possibility of ending the defined
13 benefit plan for new employees.

14

15 It is important to understand the disconnect between Duke's request for an
16 increase in pension costs in this case relative to the Company's requested
17 ROE. In general, actuarial returns for equity (stock market) returns used
18 to calculate pension benefits are in the area of 8%. Duke is using such low
19 returns to calculate pension benefits and, thereby to ask ratepayers for
20 more revenues because market returns are falling. However, the Company
21 then turns to the other side of the story and asks this Commission to
22 increase its profit margin to 10.2% citing the need to impress the capital
23 markets. It is fundamentally wrong to ask ratepayers to pay higher rates
24 for pension costs based on equity returns of approximately 8% and to pay
25 even higher rates for profit margins at 10.2%. Either the pension costs
26 should be reduced to reflect a market return at 10.2% or the ROE set in
27 this case should be set at 8%.

28

29 However, the issue of the disconnect between the actuarial return of the
30 pension plan and the ROE granted in this case would become a moot point

1 if the Company followed the lead of other Fortune 100 companies and
2 transitioned to a defined contribution retirement plan for its employees.
3 Doing so would take the burden of plan underperformance off its South
4 Carolina consumers.

5
6 **Q. PLEASE EXPLAIN WHY YOU BELIEVE DUKE SHOULD**
7 **TRANSITION TO A DEFINED CONTRIBUTION PLAN.**

8 A. A defined contribution plan, by definition, specifies an amount of money
9 that the employer must contribute to a retirement plan. The risk of the plan
10 performance transfers entirely to the employee once Duke makes the
11 retirement plan contribution. However, in a defined benefit plan, the risk
12 of plan underperformance stays with Duke. Since Duke is a regulated
13 utility, it can then shift the risk of the plan underperformance to
14 consumers. It is this shifting of the investment risk to South Carolina
15 consumers that I believe is unfair to them.

16
17 The time has come for Duke to recognize the economic realities in which
18 non-utility companies operate. The risk of plan underperformance should
19 be taken off the backs of South Carolina consumers and onto utility
20 employees. It simply is not fair to ask struggling consumers in South
21 Carolina to pay for gold-plated retirement packages of utility employees.

22
23 **Q. HOW DO YOU RESPOND TO THE COMPANY'S CRITICISM OF**
24 **YOUR STORM ADJUSTMENT?**

25 A. Duke Witness Shrum provided rebuttal testimony to my position in this
26 matter and essentially stated that the \$8.7 million requested by Duke in
27 this proceeding would bring Duke's allowable storm expenses up to its 10-
28 year normal cost levels. However, Ms. Shrum does not address my
29 statement that the Company has a \$650 million storm insurance policy in
30 place; that Duke has the ability to file for emergency rate relief if needed;

1 and the current storm reserve fund totals \$15.8 million. Ms. Shrum does
2 not present any new evidence in her testimony.

3
4 I continue to maintain that the \$8.7 million reduction to the revenue
5 requirement that I propose in my original direct testimony is prudent,
6 particularly in light of the current storm reserve fund as well as the
7 existence of the Company's storm insurance policy.

8
9 **Q. HAVE YOU REVIEWED THE COMMENTS OF DUKE WITNESS**
10 **SHRUM IN REGARD TO YOUR WEATHER NORMALIZATION**
11 **ADJUSTMENT?**

12 A. Yes.

13
14 **Q. PLEASE EXPLAIN HER DISAGREEMENT WITH YOUR**
15 **PROPOSED ADJUSTMENT.**

16 A. Ms. Shrum states that my calculation is in error because the weather in the
17 test year was "nearly normal". However, in the Company's application,
18 Duke states that \$100 million of the \$220 million request. To be specific,
19 the Company states that the \$100 million:

20
21 reflects the impact of the Company's lower sales volumes
22 during the Test Period and also reflects the net effect of
23 various increases and decreases to certain items of cost.
24 (paragraph 9 of Application)
25

26 There is clearly a conflict between what Duke has stated in its application,
27 its data request response on this matter, and Ms. Shrum's rebuttal
28 testimony. In Surrebuttal Exhibit KWO-2, I have presented the
29 Company's full response to my interrogatory in **this matter**.

1 If, as Ms. Shrum testifies, the \$79 million due to weather is normal, this
2 adjustment provides further protection from the risk of revenue diminution
3 which, in turn, compels the need to lower the stipulated ROE below 10.2%
4 to offset this lower risk of the Company.

5

6 **Q. HAVE YOU HAD A CHANCE TO REVIEW THE TESTIMONY OF**
7 **THE ORS?**

8 **A.** Yes, I have.

9 **Q. WHAT IS YOUR OBSERVATION?**

10 **A.** As usual, the ORS has done a very good job in auditing the Company's
11 books. I commend the ORS for its \$100 million in adjustments. I accept
12 their accounting adjustments. Moreover, I accept the ORS proposal to
13 offset \$45 million of the rate increase with funds from the cost of removal
14 reserve. However, with all due respect to the ORS, it did not go far
15 enough in reducing Duke's ROE request nor did the ORS go far enough in
16 reducing the revenue requirement based on just and reasonable accounting
17 adjustments such as those in my testimony.

18 **Q. WHY YOU BELIEVE THE ORS DID NOT GO FAR ENOUGH IN**
19 **THIS CASE?**

20 **A.** As I have stated above, 10.2% settlement ROE is too high for the facts in
21 this docket and is excessive when compared to other states' authorized
22 ROEs and equity ratios. If the Commission were to accept only the
23 accounting adjustments from the ORS along with the average equity ratio
24 and ROE granted year-to-date in 2013 by other state regulators, the total
25 revenue requirement would fall from \$118.7 million in the ORS testimony
26 to \$81.9 million, which equates to roughly a 5.4% one-time increase.
27 While it would be difficult, I believe consumers can absorb such a one-
28 time increase. However, if the Commission accepts the revenue

1 requirement proposed by the ORS, I recommend the Commission phase-in
2 the higher revenue requirement over a period of three years. The ORS
3 testimony increases rates by roughly 5.54% (\$ 80 Million) in year one and
4 increases rates by an additional 2.49% (\$38 Million) in year two for an
5 overall increase of 8.63% (\$118.7 Million). A three year phase in of a
6 revenue increase of \$118.7 Million would increase rates by 5.54% in year
7 one, increase rates by approximately 1.3% in year two and 1.3% in year
8 three. The values stated above can be seen in Surrebuttal Exhibit KWO-3.

9
10 **Q. WHY DO YOU BELIEVE THAT THE RATE INCREASE**
11 **PROPOSED BY DUKE AS WELL AS THAT PROPOSED BY THE**
12 **ORS IS EXCESSIVE?**

13 **A.** According to a September 2013 volume of the South Carolina Economic
14 Outlook published by the South Carolina Department of Commerce, the
15 manufacturing industry employs over 220,000 South Carolinians or
16 approximately 10 percent of the State's total work force. However, South
17 Carolina manufacturing has weakened and remains under pressure.
18 According to historical data from the US Department of Commerce,
19 Bureau of Economic Analysis, South Carolina's manufacturing industry
20 experienced a steady decrease in employment from early 2000 through the
21 decade brought on by increased pressure from globalization and
22 improvements in automation and efficiency of manufacturing plants.
23 Manufacturing employment in South Carolina remained relatively stable
24 between the levels of 350,000 and 400,000 jobs from 1970 to 2000. Over
25 the decade 2001 through 2011, South Carolina lost roughly 125,000
26 manufacturing jobs or approximately 38 percent of the 2000 level.
27 Duke's industrial load reflects this downturn. Since 2011,
28 manufacturing jobs have increased to 220,500, a 5 percent gain. However,
29 manufacturing employment has not grown but has remained flat over the

1 last 12 months. Moreover, according to the South Carolina Economic
2 Outlook, the unemployment rate in the Greenville MSA grew from 6% in
3 April 2013 to 6.5% in May 2013. The unemployment rate in the
4 Spartanburg MSA grew from 7.2% to 7.7% during the same period. South
5 Carolina's manufacturing economy has not recovered from the recession
6 and its prospects for growth remain fragile. The Kentucky report informs
7 us that job growth and the gross domestic product are blunted by electric
8 rate increases. As this Commission is aware, the merger between Duke
9 and Progress Energy will produce merger related savings and Duke will be
10 allowed to receive the entire amount of those savings. Furthermore, the
11 stipulated ROE and equity ratio in this case are both above the national
12 average, thereby providing even more of a revenue cushion for the utility
13 at the expense of consumers. Any rate increase must be just and
14 reasonable and fairly impact all customer classes. The Company's
15 requested rate increase is excessive and harms economic development, job
16 growth and job retention. The ORS testimony mitigates the impact of the
17 Duke rate increase but does not adequately address its impact on economic
18 development. My proposed rate increase of 3% establishes rates that are
19 just and reasonable to all customer classes, adequate to maintain the
20 financial stability of the Company and minimizes the adverse impact on
21 economic development. Were the Commission to accept the ORS revenue
22 proposal, a 3 year phase in of the increase better addresses the impact on
23 economic development and better mitigates the harm to employment and
24 the economy than does the 2 year phase in.

25
26 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

27 **A. Yes.**